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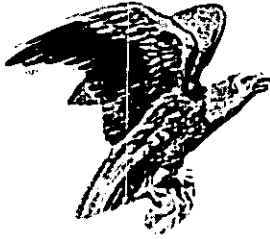


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THE SOUTHERN BANC COMPANY, INC.



THE SOUTHERN BANC COMPANY, INC.

P.O. BOX 1130, GADSDEN, ALABAMA 35902
(256) 543-3860

Dear Shareholders,

It is again my privilege to present the Annual Report for The Southern Banc Company, Inc. The report details the effect rising near term interest rates have had on our business. Borrowing short and lending long at fixed rates has never been a very good long-term strategy and these pages will bear that out. Our job has been, and continues to be, to change our balance sheet to one that can endure changes in interest rates while maintaining profitability and credit quality. As fellow investors, we are confident that our approach to change, while slow, is the best one in our business environment. As part of this strategy, we have announced that we will submit the necessary documents to eliminate our SEC filing obligations. While we expect to be a publicly traded company, we believe that this change will allow us to save money and better focus on our banking business. Please refer to the section of this report titled "Market for Common Stock and Related Stockholder Matters" for more information about this issue.

We are excited about our future and the progress we are making as a company devoted to the customer. We believe that this strategy will provide outstanding returns in the years to come. Please call me with any questions or comments and thank you again for your support of the company.

Sincerely,

Gates Little
President and Chairman
The Southern Banc Company, Inc.

THE SOUTHERN BANC COMPANY, INC.

The Southern Banc Company, Inc. (the "Company") was incorporated at the direction of management of The Southern Bank Company, formerly First Federal Savings and Loan Association of Gadsden, Alabama (the "Bank"), for the purpose of serving as the holding company of the Bank upon the acquisition of all of the capital stock issued by the Bank upon its conversion from mutual to stock form in 1995. The Company is classified as a unitary savings institution holding company and is subject to regulation by the Office of Thrift Supervision ("OTS"). At June 30, 2006, the Company had total consolidated assets of \$102.6 million, deposits of \$82.2 million and stockholders' equity of \$14.9 million, or 14.5% of total assets.

The Bank was organized in 1936 as a federally chartered mutual savings and loan association, at which time it also became a member of the Federal Home Loan Bank ("FHLB") System and obtained federal deposit insurance. The Bank currently operates through four banking offices located in Gadsden, Albertville, Guntersville and Centre, Alabama. In 1999, the Bank adopted its current corporate title.

The Bank's business strategy has been to operate as a profitable and independent community-oriented financial institution dedicated to providing quality customer service. Generally, the Bank has sought to implement this strategy by using retail deposits as its sources of funds and maintaining most of its assets in loans secured by owner-occupied one-to-four-family residential real estate properties located in the Bank's market area, consumer loans, mortgage-backed securities issued by Federal Home Loan Mortgage Corporation ("Freddie Mac"), the Government National Mortgage Association ("GNMA") and Federal National Mortgage Association ("Fannie Mae"), U.S. government and agency securities, interest-earning deposits, and cash and equivalents. The Bank's business strategy incorporates the following key elements: (1) remaining a community-oriented financial institution while maintaining a strong core customer base by providing quality service and offering customers the access to senior management and services that a community-based institution can offer; (2) attracting a retail deposit base from the communities served by the Bank's four banking offices; (3) maintaining asset quality by emphasizing investment in local residential mortgage loans, consumer loans, mortgage-backed securities and other securities issued or guaranteed by the U.S. government or agencies thereof; and (4) maintaining liquidity and capital substantially in excess of regulatory requirements.

As a federally chartered savings institution, the Bank is subject to extensive regulation by the OTS. The lending activities and other investments of the Bank must comply with various federal regulatory requirements, and the OTS periodically examines the Bank for compliance with various regulatory requirements. The Federal Deposit Insurance Corporation ("FDIC") also has the authority to conduct examinations. The Bank must file reports with the OTS describing its activities and financial condition and is also subject to certain reserve requirements promulgated by the Board of Governors of the Federal Reserve System.

MARKET FOR COMMON STOCK AND RELATED STOCKHOLDER MATTERS

At June 30, 2006, there were 809,286 shares of the Common Stock outstanding and approximately 211 stockholders of record. This total does not reflect the number of persons or entities who hold Common Stock in nominee or "street name" through various brokerage firms.

In January 2004, The Southern Banc Company, Inc. announced that its application to voluntarily delist its Common Stock from trading on the American Stock Exchange had been approved by the Securities and Exchange Commission ("SEC"). In approving this action, the Company's Board of Directors determined that it was in the best interests of the Company and its stockholders to delist. The Board considered several factors, including the following: (a) the limited number of stockholders of record, (b) the costs associated with maintaining the Company's status as a listed company, (c) the limited volume of trading of the shares, and (d) no analysts currently covering the Company and its shares. The Board of Directors determined that the costs of remaining a listed company outweighed the benefits. Due to the Company's small number of stockholders and limited trading volume, the Company did not enjoy many of the traditional benefits of being an exchange-listed company. The cost reductions associated with delisting are expected to make the Company more profitable and bring more long-term value to its stockholders.

The Company's common stock trades in the over-the-counter market on the OTC Bulletin Board[®] (OTCBB) under the symbol "SRNN." The following companies have agreed to make a market in the common stock as long as the volume of trading and certain other market making considerations justify such activity- Sterne, Agee & Leach, Inc., Crown Financial Group, Inc., Hill Thompson Magid & Co., Inc., Monroe Securities, Inc., and Knight Equity Markets, L.P.

On September 19, 2006 the Company announced that it will file a Form 15 with the Securities and Exchange Commission and cease filing periodic reports with the SEC under the Securities Exchange Act of 1934. The Company expects to take this action shortly after the annual meeting of the stockholders. As of the date of filing the Form 15, the Company will no longer file periodic reports with the SEC, including Forms 10-KSB, 10-QSB and 8-K. Factors influencing the Company's decision include: (a) the administrative and third party professional costs associated with being a SEC "reporting company" under the 1934 Act, including significant additional costs arising under the Sarbanes-Oxley Act of 2002, (b) the increased time to be available for management to focus on growing the Company's business and (c) the limited trading in the Company's common stock.

The payment of dividends on the Common Stock is subject to determination and declaration by the Board of Directors of the Company. The Board of Directors has adopted a policy of paying quarterly cash dividends on the Common Stock. In addition, from time to time, the Board of Directors may pay special cash dividends in addition to, or in lieu of, regular cash dividends. The payment of future dividends will be subject to the requirements of applicable law and the determination by the Board of Directors of the Company that the net income, capital and financial condition of the Company and the Bank, thrift industry trends and general economic conditions, justify the payment of dividends. There can be no assurance that future dividends will be paid. The Company's principal source of funds for dividend payments is dividends from the Bank. See Note 11 of Notes to Consolidated Financial Statements.

The following table sets forth information as to high and low sales prices of the Company's Common Stock and cash dividends declared per share of Common Stock for the calendar quarters indicated.

	Price Per Share		Dividends Per Share
	High	Low	
Fiscal 2005			
First Quarter*	\$17.75	\$16.75	\$.0875
Second Quarter*	\$17.60	\$17.00	\$.0875
Third Quarter*	\$17.00	\$15.75	\$.0875
Fourth Quarter*	\$18.00	\$15.10	\$.0875
Fiscal 2006			
First Quarter*	\$18.10	\$16.30	\$.0875
Second Quarter*	\$16.85	\$16.15	\$.0875
Third Quarter*	\$16.25	\$15.30	\$.0875
Fourth Quarter*	\$17.25	\$15.30	\$.0875

On January 8, 2004, the Company voluntarily delisted its Common Stock from trading on the American Stock Exchange. Since that date, the Common Stock has traded in the OTCBB. Over-the-counter quotations reflect inter-dealer prices, without retail mark-up, mark-down or commission, and may not reflect actual transactions.

SELECTED CONSOLIDATED FINANCIAL AND OTHER DATA

	Year Ended June 30,				
	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>
	(In thousands, except per share data)				
INCOME STATEMENT DATA					
Interest income.....	\$ 4,958	\$ 4,967	\$ 5,007	\$ 5,890	\$ 6,299
Interest expense	<u>2,642</u>	<u>2,236</u>	<u>2,119</u>	<u>2,898</u>	<u>3,566</u>
Net interest income.....	2,316	2,731	2,888	2,992	2,733
Provision for loan losses.....	<u>15</u>	<u>15</u>	<u>12</u>	<u>13</u>	<u>27</u>
Net interest income after provision for loan losses	2,301	2,716	2,876	2,979	2,706
Non-interest income.....	311	536	235	524	183
Non-interest expense	<u>2,235</u>	<u>2,209</u>	<u>2,153</u>	<u>2,013</u>	<u>1,853</u>
Income before provision for income taxes....	377	1,043	958	1,490	1,036
Provision for income taxes	<u>142</u>	<u>393</u>	<u>381</u>	<u>596</u>	<u>403</u>
Net income.....	<u>\$ 235</u>	<u>\$ 650</u>	<u>\$ 577</u>	<u>\$ 894</u>	<u>\$ 633</u>
Earnings per share					
Basic	<u>\$ 0.30</u>	<u>\$ 0.78</u>	<u>\$ 0.66</u>	<u>\$ 1.02</u>	<u>\$ 0.69</u>
Diluted	<u>\$ 0.29</u>	<u>\$ 0.76</u>	<u>\$ 0.63</u>	<u>\$ 1.00</u>	<u>\$ 0.69</u>

	Year Ended June 30,				
	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>
	(In thousands)				
BALANCE SHEET DATA					
Total assets	\$102,649	\$ 104,811	\$ 106,353	\$ 111,701	\$ 110,002
Loans receivable, net	33,710	35,531	37,477	38,918	34,515
Securities:					
Available for sale.....	57,623	59,403	56,717	53,723	53,753
Held to maturity	2,580	3,660	4,194	7,215	11,527
Federal Home Loan Bank stock.....	494	509	792	886	1,449
Deposits	82,170	81,737	82,005	84,357	81,557
Federal Home Loan Bank advances.	5,250	6,083	6,917	7,750	9,583
Stockholders' equity	14,940	16,703	17,253	18,866	18,344

	Year Ended June 30,				
	<u>2006</u>	<u>2005</u>	<u>2004</u>	<u>2003</u>	<u>2002</u>
KEY OPERATING DATA					
Return on average assets.....	0.23%	0.61%	0.54%	0.80%	0.58%
Return on average equity	1.51 %	3.73%	3.25%	4.68%	3.48%
Average equity to average assets	15.18 %	16.27%	16.67%	17.02%	16.62%
Dividend payout ratio	116.67 %	43.75%	53.03%	31.31%	48.61%
Number of offices	4	4	4	4	4

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

General

The principal business of the Company consists of accepting deposits from the general public through the Bank's main and branch offices and investing those funds in loans secured by one-to-four family residential properties and consumer loans located in the Bank's primary market area. Due to the competition for one-to-four family mortgage loans and consumer loans in the Bank's market area, the Bank maintains a substantial portfolio of investment and mortgage-backed securities. The Bank's mortgage-backed securities are all guaranteed as to principal and interest by GNMA, Freddie Mac or Fannie Mae. The Bank's securities portfolio consists primarily of mortgage backed securities, government agency securities, including agency notes and U. S. Treasury Notes. See Notes 2 and 3 of Notes to Consolidated Financial Statements. The Bank maintains a substantial amount in interest-bearing deposits in other banks, primarily interest-bearing accounts with the FHLB of Atlanta and Compass Bank.

The Company's net income is dependent primarily on the Bank's net interest income, which is the difference between interest income earned on its loans, mortgage-backed securities and securities portfolio and interest paid on customers' deposits and any other borrowings. The Company's net income is also affected by the Bank's level of non-interest income, such as service charges on customers' deposit accounts, net gains or losses on the sale of securities and other fees. In addition, net income is affected by the level of non-interest expense, primarily consisting of compensation and employee benefit expense, data processing expense, professional service expense, office building and equipment expense, and other expenses.

The operations of the Company and the financial institution industry as a whole are significantly affected by prevailing economic conditions, competition and the monetary and fiscal policies of governmental agencies. Lending activities are influenced by the economy and supply of housing and competition among lenders and the level of interest rates in the Bank's market area. The Bank's deposit flows and costs of funds are influenced by prevailing market rates of interest, primarily on competing investments, account maturities, and the levels of personal income and savings in the Bank's market area.

Comparison of Financial Condition at June 30, 2006 and June 30, 2005

Total assets decreased approximately \$2.2 million, or 2.0%, from \$104.8 million at June 30, 2005 to \$102.6 million at June 30, 2006. During the year ended June 30, 2006, net loans decreased approximately \$1.8 million, or 5.1%, from \$35.5 million to \$33.7 million. The decrease in net loans was primarily attributable to loan repayments and a decrease in origination of new loans. For the period ended June 30, 2006, securities available for sale decreased approximately \$1.8 million, or 3.0%, from \$59.4 million to \$57.6 million. During the period ended June 30, 2006, securities held to maturity decreased approximately \$1.1 million, or 29.5%, from \$3.7 million to \$2.6 million.

Cash and cash equivalents increased approximately \$1.6 million, or 39.6%, from \$4.1 million at June 30, 2005 to \$5.7 million at June 30, 2006. This increase was primarily attributable to maturities of securities available for sale and securities held to maturity, and loan repayments offset in part by stock repurchases of approximately \$852,000.

Accrued interest and dividends receivable increased approximately \$68,000, or 15.5%, from \$441,000 at June 30, 2005 to \$509,000 at June 30, 2006. This increase was primarily attributable to an increase in interest receivable on securities available for sale. Prepaid expenses and other assets increased approximately \$339,000, or 61.4%, from \$552,000 at June 30, 2005 to \$891,000 at June 30, 2006. The increase in prepaid expenses and other assets was primarily attributable to an increase in the deferred tax benefit associated with the unrealized loss on securities available for sale of approximately \$659,000, offset by a reclassification of new branch real estate investment from other assets to premises and equipment of approximately \$451,000.

Total deposits increased approximately \$433,000, or 0.5%, from \$81.7 million at June 30, 2005 to \$82.2 million at June 30, 2006. FHLB advances decreased approximately \$833,000, or 13.7%, from \$6.1 million at June

30, 2005 to \$5.3 million at June 30, 2006. The decrease in FHLB Advances was attributable to repayments based on the fixed payment schedule. Other liabilities during the fiscal year ended June 30, 2006 increased approximately \$1,000, or 0.4%, from \$289,000 at June 30, 2005 to \$290,000 at June 30, 2006.

Total equity decreased approximately \$1.8 million, or 10.6%, from \$16.7 million at June 30, 2005 to \$14.9 million at June 30, 2006. This decrease was primarily attributable to an increase in the unrealized losses on securities available for sale, payment of cash dividends on common stock, and stock repurchases.

Comparison of Results of Operations for the Fiscal Years Ended June 30, 2006 and 2005

The Company reported net income for the fiscal years ended June 30, 2006 and 2005 of approximately \$235,000 and \$650,000, respectively. The decrease in net income for the fiscal year ended June 30, 2006 was primarily attributable to a \$296,000, or 81.8%, decrease in the gain on sale of securities.

Net Interest Income. Net interest income decreased approximately \$415,000, or 15.2%, from \$2.7 million at June 30, 2005 to \$2.3 million at June 30, 2006. This decrease was primarily attributable to decreases in interest and fees on loans and securities held to maturity of approximately \$36,000, or 1.7% and \$115,000, or 43.7% respectively. Total interest income decreased approximately \$9,000, or 0.2%, for the fiscal year ended June 30, 2006. Total interest expense increased approximately \$406,000, or 18.2%, for the fiscal year ended June 30, 2006 compared with the fiscal year ended June 30, 2005. The increase in total interest expense was primarily attributable to an increase in the average cost of interest-bearing liabilities during a period of rising interest rates.

Provision for Loan Losses. During the fiscal years ended June 30, 2006 and 2005, the Company recorded provision for loan losses of approximately \$15,000. The allowance for loan losses is based on management's evaluation of possible loan losses inherent in the Bank's loan portfolio. Management considers, among other factors, past loss experience, current economic conditions, volume, growth and composition of the loan portfolio, and other relevant factors.

Non-Interest Income. Non-interest income decreased approximately \$225,000, or 41.9%, for the fiscal year ended June 30, 2006. The decrease in non-interest income was primarily attributable a decrease in the gain on sale of securities of approximately \$296,000 offset in part by an increase in other miscellaneous income of approximately \$70,000. The increase in other miscellaneous income was primarily attributable to a reclassification gain of approximately \$56,000 associated with investments formerly held as trading securities. During the fiscal year ended June 30, 2005, the Company recorded a gain on the sale of stock owned by the Company in its data processing service bureau of approximately \$329,000.

Non-Interest Expense. Non-interest expense increased approximately \$26,000, or 1.2%, for the fiscal year ended June 30, 2006. This increase was primarily attributable to an increase in office building and equipment expenses of approximately \$58,000, or 32.9%, and an increase in data processing expense of approximately \$19,000, or 7.9%, offset by a decrease in salaries and employee benefits of approximately \$18,000, or 1.4%, and a decrease in professional service expense of approximately \$13,000 or 6.7%, and a decrease in other operating expenses of approximately \$20,000, or 6.2%. The increase in data processing expense was primarily attributable to purchases of computer equipment and payments for services associated with the upgrade of the Bank's core processing system. The decreases in other operating expenses were primarily attributable to reduced expenses related to employee benefits and legal fees.

Provision for Income Taxes. During the fiscal year ended June 30, 2006, the provision for income tax expense decreased approximately \$251,000, or 63.8%. This decrease was primarily attributable to a decrease in taxable net income for the year ended June 30, 2006, as compared to the year ended June 30, 2005. Income tax expense was approximately \$142,000 for the year ended June 30, 2006, compared to approximately \$394,000 for the year ended June 30, 2005, resulting in an effective tax rate of 38% for fiscal 2005 and 2006. The statutory federal tax rate in both years was 34%. See Note 8 of Notes to Consolidated Financial Statements for a reconciliation between the statutory tax rate and the effective tax rate.

Asset/Liability Management

Net interest income, the primary component of the Company's net income, is determined by the difference or "spread" between the yields earned on the Bank's interest-earning assets and the rates paid on its interest-bearing liabilities and the relative amounts of such assets and liabilities. Key components of a successful asset/liability strategy are the monitoring and managing of interest rate sensitivity on both the interest-earning assets and interest-bearing liabilities. The matching of the Bank's assets and liabilities may be analyzed by examining the extent to which its assets and liabilities are interest rate sensitive and by monitoring the expected effects of interest rate changes on an institution's net portfolio value.

An asset or liability is interest rate sensitive within a specific time period if it will mature or reprice within that time period. If the Bank's assets mature or reprice more quickly or to a greater extent than its liabilities, the Bank's net portfolio value and net interest income would tend to increase during periods of rising interest rates but decrease during periods of falling interest rates. If the Bank's assets mature or reprice more slowly or to a lesser extent than its liabilities, the Bank's net portfolio value and net interest income would tend to decrease during periods of rising interest rates but increase during periods of falling interest rates. The Bank's policy has been to seek to mitigate the interest rate risk inherent in the historical savings institution business of originating long term loans funded by short term deposits by pursuing the following strategies: (i) the Bank has historically maintained substantial liquidity and capital levels to sustain unfavorable movements in market interest rates; and (ii) in order to minimize the adverse effect of interest rate risk on future operations, the Bank purchases adjustable- and fixed-rate securities with maturities of primarily five to fifteen years and originates limited amounts of shorter term consumer loans.

The OTS requires the Bank to measure its interest rate risk by computing estimated changes in the net present value ("NPV") of its cash flows from assets, liabilities and off-balance sheet items in the event of a range of assumed changes in market interest rates. These computations estimate the effect on the Bank's NPV of sudden and sustained 100 basis point to 400 basis point increases and decreases in market interest rates. The Bank's Board of Directors has adopted an interest rate risk policy which establishes maximum increases in the Bank's estimated NPV of 25%, 50% and 77% and maximum decreases of 25%, 35% and 50% in the event of 100, 200 and 300 basis point increases and decreases in market interest rates, respectively. At March 21, 2006, based on the most recent information provided by the OTS, management estimated that the Bank's NPV would increase 10% and 17% and decrease 12%, 23% and 34% in the event of 100 and 200 basis point increases and a 100, 200 and 300 basis point decreases in market interest rates, respectively. These calculations indicate that the Bank's net portfolio value could be adversely affected by increases in interest rates. Changes in interest rates also may affect the Bank's net interest income, with increases in rates expected to decrease income and decreases in rates expected to increase income, as the Bank's interest-bearing liabilities would be expected to mature or reprice more quickly than the Bank's interest-earning assets.

Computations of prospective effects of hypothetical interest rate changes are based on numerous assumptions, including relative levels of market interest rates, prepayments and deposit run-offs and should not be relied upon as indicative of actual results. Certain shortcomings are inherent in such computations. Although certain assets and liabilities may have similar maturity or periods of repricing, they may react at different times and in different degrees to changes in the market interest rates. The interest rates on certain types of assets and liabilities may fluctuate in advance of changes in market interest rates, while rates on other types of assets and liabilities may lag behind changes in market interest rates. Certain assets, such as adjustable rate mortgages, generally have features which restrict changes in interest rates on a short term basis and over the life of the asset. In the event of a change in interest rates, prepayments and early withdrawal levels could deviate significantly from those assumed in making calculations set forth above. Additionally, an increased credit risk may result as the ability of many borrowers to service their debt may decrease in the event of an interest rate increase. Finally, virtually all of the adjustable rate loans in the Bank's portfolio contain conditions which restrict the periodic change in interest rate.

The Bank's Board of Directors is responsible for reviewing the Bank's asset and liability policies. On at least a quarterly basis, the Board reviews interest rate risk and trends, as well as liquidity and capital ratios and requirements. The Bank's management is responsible for administering the policies and determinations of the Board of Directors with respect to the Bank's asset and liability goals and strategies. Management expects that the

Bank's asset and liability policies and strategies will continue as described above so long as competitive and regulatory conditions in the financial institution industry continue as they have in recent years.

Average Balance, Interest and Average Yields and Rates

The following table sets forth certain information relating to the Company's average interest-earning assets and interest-bearing liabilities and reflects the average yield on assets and the average cost of liabilities for the periods and at the dates indicated. Such yields and costs are derived by dividing income or expense by the average monthly balance of assets or liabilities, respectively, for the periods indicated.

The table also presents information for the periods indicated with respect to the difference between the weighted average yield earned on interest-earning assets and the weighted average rate paid on interest-bearing liabilities, or "interest rate spread," which savings institutions have traditionally used as an indicator of profitability. Another indicator of an institution's net interest income is its "net yield on interest-earning assets," which is its net interest income divided by the average balance of interest-earning assets. Net interest income is affected by the interest rate spread and by the relative amounts of interest-earning assets and interest-bearing liabilities. When interest-earning assets approximate or exceed interest-bearing liabilities, any positive interest rate spread will generate net interest income.

	Years Ended June 30,					
	2006			2005		
	Average Balance	Interest	Average Yield/ Cost (Dollars in thousands)	Average Balance	Interest	Average Yield/ Cost
Interest-earning assets:						
Loans receivable	\$35,005	\$ 2,006	5.73%	\$35,868	\$ 2,042	5.69%
Securities	60,216	2,818	4.68	63,233	2,865	4.53
Other interest-earning assets	1,984	134	6.75	2,598	60	2.31
Total interest-earning assets	97,205	4,958	5.10	101,699	4,967	4.89
Non-interest-earning assets	5,653			5,058		
Total assets	<u>\$102,858</u>			<u>\$106,757</u>		
Interest-bearing liabilities:						
Deposits	\$ 80,852	2,377	2.94	\$ 82,273	1,937	2.36
FHLB advances	5,719	265	4.63	6,555	299	4.56
Total interest-bearing liabilities ..	86,571	2,642	3.05	88,828	2,236	2.52
Non-interest-bearing liabilities	669			521		
Total liabilities	87,240			89,349		
Stockholders' Equity	15,618			17,408		
Total liabilities and equity	<u>\$102,858</u>			<u>\$106,757</u>		
Net interest income		\$ 2,316			\$ 2,731	
Interest rate spread			2.05%			2.37%
Net interest margin			2.38%			2.69%
Ratio of average interest-earning assets to average interest-bearing liabilities			112.28%			114.49%

Rate/Volume Analysis

The table below sets forth certain information regarding changes in interest income and interest expense of the Company for the periods indicated. For each category of interest-earning asset and interest-bearing liability, information is provided on changes attributable to: (i) changes in volume (changes in volume multiplied by old rate) and (ii) changes in rates (changes in rate multiplied by old volume).

	Year Ended June 30,		
	2006 vs. 2005		
	Increase (Decrease)		
	Due to		
	Rate	Volume	Total
	(In thousands)		
Interest income			
Loans	\$ 13	\$ (49)	\$ (36)
Securities	141	(137)	4
Other interest-earning assets	56	(34)	22
Total interest-earning assets	210	(220)	(10)
Interest expense			
Deposits	472	(33)	439
Interest on FHLB advances	4	(38)	(34)
Total interest-bearing liabilities	476	(71)	405
Change in net interest income	\$ (266)	\$ (149)	\$ (415)

Liquidity and Capital Resources

As a thrift holding company, the Company conducts its business through its subsidiary, the Bank, which is required to maintain minimum levels of liquid assets as defined by regulations of the OTS. The requirement, which varies from time to time depending upon economic conditions and deposit flows, is based upon a percentage of deposits and short-term borrowings. The required ratio currently is 4.0%. The Bank adjusts its liquidity levels in order to meet funding needs of deposit outflows, repayment of borrowings and loan commitments. The Bank also adjusts liquidity as appropriate to meet its asset and liability management objectives.

The Bank's primary sources of funds are deposits, payment of loans and mortgage-backed securities, maturities of investment securities and other investments. While scheduled principal repayments on loans and mortgage-backed securities are a relatively predictable source of funds, deposit flows and loan prepayments are greatly influenced by general interest rates, economic conditions and competition. The Bank invests in short-term interest-earning assets which provide liquidity to meet lending requirements.

The Bank continues to maintain a high level of liquid assets in order to meet its funding requirements. At June 30, 2006, the Bank had approximately \$5.7 million in cash on hand and interest-bearing deposits in other banks, which represented 5.6% of total assets. The Bank's average liquidity ratio well exceeded the required minimum at and during the fiscal year ended June 30, 2006. At June 30, 2006, the Bank's level of liquid assets, as measured for regulatory compliance purposes, was \$17.7 million, or 25.42% of total liquid assets of the Bank.

At June 30, 2006, the Bank had \$14.3 million of total equity, or 13.6% of total assets. The Bank continued to exceed its regulatory capital requirement ratios at June 30, 2006. Tangible capital and core capital were each \$14.3 million, which represented 13.6% of adjusted total assets, and risk-based capital was \$14.4 million, which represented 35.1% of total risk-weighted assets at June 30, 2006. Such amounts exceeded the respective minimum required ratios of 1.5%, 4.0% and 8.0% by 12.1%, 9.6% and 27.1%, respectively. At June 30, 2006, the Bank continued to meet the definition of a "well-capitalized" institution, the highest of the five categories under the prompt corrective action standards adopted by the OTS. See Note 11 of Notes to Consolidated Financial Statements.

Contractual Obligations

The following table sets forth the contractual obligations of the Bank as of June 30, 2006.

	One Year or Less	Over One through Three Years	Over Three through Five Years (In thousands)	Over Five Years	Total
FHLB advances ⁽¹⁾	\$ 3,833	\$ 1,417	\$ 0	\$ 0	\$ 5,250
Certificates of deposit ⁽²⁾	13,010	35,713	12,986	1,393	63,102
Total	<u>\$ 16,843</u>	<u>\$ 37,130</u>	<u>\$ 12,986</u>	<u>\$ 1,393</u>	<u>\$ 68,352</u>

(1) See Note 9 of Notes to Consolidated Financial Statements.

(2) See Note 7 of Notes to Consolidated Financial Statements.

Off-Balance Sheet Arrangements

The following table sets forth off-balance sheet arrangements of the Bank as of June 30, 2006.

	One Year or Less	Over One through Three Years	Over Three through Five Years (In thousands)	Over Five Years	Total
Lines of credit – consumer	\$ 0	\$ 0	\$ 1,609	\$ 0	\$ 1,609
Lines of credit–commercial	225	0	0	0	225
Commitments to originate real estate loans	310	0	0	0	310
Overdraft protection	17	0	0	0	17
Total	<u>\$ 552</u>	<u>\$ 0</u>	<u>\$ 1,609</u>	<u>\$ 0</u>	<u>\$ 2,161</u>

In the normal course of business, the Bank is a party to activities that contain credit, market and operational risk that are not reflected in the Company's Consolidated Financial Statements. The Bank provides customers with off-balance sheet credit support through loan commitments and lines of credit. Many of the commitments expire unused or are only partially used. Therefore, the total amount of commitments does not necessarily represent future cash demand requirements. The Company anticipates that the Bank will continue to have sufficient funds together with available borrowings to satisfy its commitments. See Note 10(b) of Notes to Consolidated Financial Statements.

Critical Accounting Policy

The accounting principles followed by the Company and the methods of applying principles conform with accounting principles generally accepted in the United States and with general practices followed by the banking industry. The most critical accounting policy relates to the allowance for loan losses.

The allowance for loan losses is maintained at a level which management considers to be adequate to absorb losses inherent in the loan portfolio. Management's estimation of the amount of the allowance is based on a continuing evaluation of the loan portfolio and includes such factors as economic conditions, analysis of individual loans, overall portfolio characteristics, delinquencies and balance of any impaired loans (generally considered to be nonperforming loans, excluding residential mortgages and other homogeneous loans).

Management reviews the adequacy of the allowance for loan losses on a continuous basis by assessing the quality of the loan portfolio and adjusting the allowance when appropriate. Management's evaluation of certain specifically identified loans includes a review of the financial condition and capacity of the borrower, the value of the collateral, current economic trends, historical losses, workout and collective arrangements, and possible concentrations of credit. The loan review process also includes a collective evaluation of credit quality within the mortgage and installment loan portfolios. In establishing the allowance, loss percentages are applied to groups of loans with similar risk characteristics. These loss percentages are determined by historical experience, portfolio

mix, regulatory influence, and other economic factors. Each month this review is quantified in a report to management, which uses it to determine whether an appropriate allowance is being maintained. This report is then submitted to the Board of Directors monthly.

Changes in the allowance can result from changes in economic events or changes in the creditworthiness of the borrowers. The effect of these changes is reflected when known. Though management believes the allowance for loan losses to be adequate, ultimate losses may vary from estimations. Specific allowances for impaired loans are generally based on comparisons of the carrying values of the loans to the estimated fair value of the collateral.

Impaired loans (generally considered to be nonperforming loans, excluding residential mortgages and other homogeneous loans) are measured based on the present value of expected future cash flows discounted at each loan's original effective interest rate. As a practical expedient, impairment is measured based on the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. When the measure of the impaired loan is less than the recorded investment of the loan, the impairment is recorded through a valuation allowance.

The Company ceases accrual of interest on a loan when payment on the loan is in excess of 90 days past due. Income is subsequently recognized only to the extent that cash payments are received until, in management's judgment, the borrower's ability to make periodic interest and principal payments has been reestablished, in which case the loan is returned to accrual status.

Recent Accounting Pronouncements

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 123 (revised 2004) *Share-Based Payment*. The Statement is a revision of FASB Statement No. 123, *Accounting for Stock-Based Compensation*. This Statement supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and its related implementation guidance. The Statement establishes standards for accounting for transactions in which an entity exchanges its equity instruments for goods or services. It also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments. The Statement focuses primarily on accounting for transactions in which an entity obtains employee service in share-based payment transactions. The Statement requires a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award (with limited exceptions). That cost will be recognized over the period during which an employee is required to provide service in exchange for the award- the requisite service period (usually the vesting period). No compensation cost is recognized for equity instruments for which employees do not render the requisite service. The Statement eliminates the alternative to use APB Opinion 25's intrinsic value method of accounting that was provided in Statement 123 as originally issued. Under Opinion 25, issuing stock options to employees generally resulted in recognition of no compensation cost. The Statement is effective for public entities that file as small business issuers as of the beginning of the first annual reporting period that begins after December 15, 2005. The Company adopted the Statement on July 1, 2006, and is currently evaluating the effects on the Company's financial statements.

In May 2005, the FASB issued Statement of Financial Accounting Standards No. 154, "Accounting Changes and Error Corrections — a replacement of APB Opinion No. 20 and FASB Statement No. 3" (Statement 154). Statement 154 changes the requirements for the accounting for and reporting of a change in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. When a pronouncement includes specific transition provisions, those provisions should be followed. Statement 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company does not expect the adoption of Statement 154 to have a material effect on the consolidated financial statements.

In November 2005, the FASB issued Staff Position Statement of Financial Accounting Standards 115-1, "The Meaning of Other than-Temporary Impairment and Its Application to Certain Investments" (FSP 115-1). This FSP outlines guidance for determining when an investment is considered impaired, when such impairment is considered other than temporary and the measurement of any resulting impairment loss. FSP 115-1 also provides certain disclosure requirements for securities and their fair values. The FSP is effective for reporting periods beginning after December 15, 2005. The Company does not expect the adoption of this FSP to have a material impact on the consolidated financial statements.

Forward-Looking Statements

Management's discussion and analysis includes certain forward-looking statements addressing, among other things, the Company's prospects for earnings, asset growth and net interest margin. Forward-looking statements are accompanied by, and identified with, such terms as "anticipates," "believes," "expects," "intends," and similar phrases. Management's expectations for the Company's future involve a number of assumptions and estimates. Factors that could cause actual results to differ from the expectations expressed herein include: substantial changes in interest rates, and changes in the general economy; and changes in the Bank's strategies for credit-risk management, interest-rate risk management and investment activities. Accordingly, any forward-looking statements included herein do not purport to be predictions of future events or circumstances and may not be realized.

Change in Independent Registered Public Accounting Firm

On December 3, 2004, the Audit Committee dismissed the Company's independent registered public accounting firm, KPMG LLP ("KPMG"), and appointed Barfield, Murphy, Shank & Smith, P.C. ("BMSS") as its new independent registered public accounting firm. This determination followed the Company's decision to seek proposals from independent accountants to audit the Company's financial statements for the fiscal year ended June 30, 2005. The decision not to renew the engagement of KPMG and to retain BMSS was approved by the Audit Committee. KPMG's report on the Company's 2004 financial statements dated August 3, 2004, was issued in conjunction with the filing of the Company's Annual Report on Form 10-KSB for the fiscal year ended June 30, 2004.

During the Company's two most recent fiscal years ended June 30, 2004, and the subsequent interim period through December 3, 2004, there were no disagreements between the Company and KPMG on any matter of accounting principles or practices, financial statement disclosure, or auditing scope or procedure, which disagreement(s), if not resolved to KPMG's satisfaction, would have caused KPMG to make reference thereto in their reports on the financial statements for such fiscal years.

The audit reports of KPMG on the consolidated financial statements of the Company and subsidiary as of and for the fiscal years ended June 30, 2004 and 2003 did not contain any adverse opinion or disclaimer of opinion, nor were they qualified or modified as to uncertainty, audit scope, or accounting principle.

During the Company's two most recent fiscal years ended June 30, 2004 and the subsequent interim period through December 3, 2004, there have been no reportable events (as defined in Regulation S-B Item 304(a)(1)(iv)(B)).

The Company requested that KPMG furnish it with a letter addressed to the Securities and Exchange Commission stating whether or not KPMG agreed with the above statements. A copy of such letter, dated December 9, 2004, was filed as Exhibit 16.1 to the Company's Current Report on Form 8-K dated December 3, 2004, as amended.

During the Company's two most recent fiscal years ended June 30, 2004, and the subsequent interim period through December 3, 2004, the Company did not consult with BMSS regarding any of the matters or events set forth in Item 304(a)(2)(i) and (ii) of Regulation S-B.



1121 Riverchase Office Road
Birmingham, Alabama 35244
205-982-5500
Fax 205-982-5501
www.bmss.com

Keith M. Barfield, CPA
Donald W. Murphy, Jr., CPA
John P. Shank, CPA
Steven N. Smith, CPA
Dianne L. Hart, CPA
Myra S. Roberts, CPA
A. Jackson Knight, CPA
David R. King
Derrel G. Curry, CPA

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Board of Directors and Shareholders
of The Southern Banc Company, Inc.

We have audited the accompanying consolidated statements of financial condition of The Southern Banc Company, Inc. (a Delaware corporation) and subsidiaries as of June 30, 2006 and 2005, and the related consolidated statements of income, stockholders' equity, and cash flows for the years then ended. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. The company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. Our audit included consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the company's internal control over financial reporting. Accordingly, we express no such opinion. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of The Southern Banc Company, Inc. and subsidiaries as of June 30, 2006 and 2005, and the results of their operations and their cash flows for the years then ended in conformity with accounting principles generally accepted in the United States of America.

Barfield, Murphy, Shank & Smith, P.C.

Birmingham, Alabama
August 18, 2006

THE SOUTHERN BANC COMPANY, INC.

Consolidated Statements of Financial Condition

June 30, 2006 and 2005

Assets	2006	2005
Cash and cash equivalents:		
Cash on hand and in other banks	\$ 2,116,505	2,364,078
Interest-bearing deposits in other banks	3,614,432	1,742,422
Total cash and cash equivalents	5,730,937	4,106,500
Securities available for sale, at fair value	57,623,030	59,403,333
Securities held to maturity (fair value of \$2,615,941 and \$3,784,984, respectively)	2,580,447	3,660,129
Federal Home Loan Bank stock	494,400	508,900
Loans held for sale	63,200	—
Loans receivable, net of allowance for loan losses of \$138,939 and \$135,472, respectively	33,710,252	35,530,975
Accrued interest and dividends receivable	509,215	440,952
Premises and equipment, net	1,046,463	608,840
Prepaid expenses and other assets	891,419	551,744
Total assets	\$ 102,649,363	104,811,373
Liabilities and Stockholders' Equity		
Deposits	\$ 82,169,673	81,736,517
Federal Home Loan Bank advances	5,250,000	6,083,334
Other liabilities	289,862	288,579
Total liabilities	87,709,535	88,108,430
Commitments and contingencies		
Stockholders' equity:		
Preferred stock, par value \$0.01 per share. Authorized 500,000 shares; no shares issued and outstanding	—	—
Common stock, par value \$0.01 per share. Authorized 3,500,000 shares; issued 1,454,750 shares in 2006 and 2005	14,548	14,548
Additional paid-in capital	13,997,847	13,997,847
Retained earnings	11,652,772	11,696,782
Shares held in trust, at cost, 27,768 and 49,355 shares in 2006 and 2005, respectively	(599,755)	(868,350)
Treasury stock, at cost, 645,464 and 595,090 shares in 2006 and 2005, respectively	(8,775,687)	(7,923,346)
Accumulated other comprehensive loss	(1,349,897)	(214,538)
Total stockholders' equity	14,939,828	16,702,943
Total liabilities and stockholders' equity	\$ 102,649,363	104,811,373

See accompanying notes to consolidated financial statements.

THE SOUTHERN BANC COMPANY, INC.

Consolidated Statements of Income

Years ended June 30, 2006 and 2005

	2006	2005
Interest income:		
Interest and fees on loans	\$ 2,005,869	2,041,503
Interest and dividends on securities available for sale	2,669,132	2,601,573
Interest and dividends on securities held to maturity	148,563	263,843
Other interest income	134,490	59,999
Total interest income	4,958,054	4,966,918
Interest expense:		
Interest on deposits	2,376,740	1,937,155
Interest on borrowed funds	265,034	298,534
Total interest expense	2,641,774	2,235,689
Net interest income before provision for loan losses	2,316,280	2,731,229
Provision for loan losses	15,000	15,000
Net interest income after provision for loan losses	2,301,280	2,716,229
Noninterest income:		
Customer service fees	123,415	122,494
Gain on sale of available for sale securities	66,009	361,650
Other income	122,018	51,661
Total noninterest income	311,442	535,805
Noninterest expense:		
Salaries and employee benefits	1,254,071	1,271,604
Data processing expense	255,985	237,257
Professional service expense	186,447	199,767
Office building and equipment expense	236,348	177,861
Other expense	302,238	322,256
Total noninterest expense	2,235,089	2,208,745
Income before provision for income taxes	377,633	1,043,289
Provision for income taxes	142,368	393,693
Net income	\$ 235,265	649,596
Earnings per share:		
Basic	\$ 0.30	0.78
Diluted	0.29	0.76
Average shares outstanding – basic	796,289	836,034
Average shares outstanding – diluted	808,418	854,353

See accompanying notes to consolidated financial statements.

THE SOUTHERN BANC COMPANY, INC.
Consolidated Statements of Stockholders' Equity
Years ended June 30, 2006 and 2005

	Common stock	Additional paid-in capital	Retained earnings	Unearned compensation	Shares held in trust	Treasury stock	Accumulated other comprehensive income (loss)	Total
Balance, June 30, 2004	\$ 14,548	13,910,384	11,340,830	(70,715)	(495,412)	(7,346,782)	(100,186)	17,252,667
Net income	—	—	649,596	—	—	—	—	649,596
Change in unrealized gain on securities available for sale, net of tax	—	—	—	—	—	—	(114,352)	(114,352)
Comprehensive income	—	—	—	—	—	—	—	535,244
Amortization of unearned compensation	—	87,463	—	70,715	—	—	—	158,178
Purchase of 32,638 shares of treasury stock	—	—	—	—	—	(576,564)	—	(576,564)
Purchase of 49,073 shares of common stock to fund Trust	—	—	—	—	(778,080)	—	—	(778,080)
Stock Options exercised	—	—	(293,644)	—	405,142	—	—	405,142
Dividends paid (\$0.35 per share)	—	—	—	—	—	—	—	(293,644)
Balance, June 30, 2005	14,548	13,997,847	11,696,782	—	(868,350)	(7,923,346)	(214,538)	16,702,943
Net income	—	—	235,265	—	—	—	—	235,265
Change in unrealized loss on securities available for sale, net of tax	—	—	—	—	—	—	(1,099,969)	(1,099,969)
Comprehensive loss	—	—	—	—	—	—	—	(864,704)
Reclassification gain on securities	—	—	—	—	—	—	(35,390)	(35,390)
Purchase of 50,374 shares of treasury stock	—	—	—	—	—	(852,341)	—	(852,341)
Stock Options exercised	—	—	—	—	268,595	—	—	268,595
Dividends paid (\$0.35 per share)	—	—	(279,275)	—	—	—	—	(279,275)
Balance, June 30, 2006	\$ 14,548	13,997,847	11,652,772	—	(599,755)	(8,775,687)	(1,349,897)	14,939,828

See accompanying notes to consolidated financial statements.

THE SOUTHERN BANC COMPANY, INC.

Consolidated Statements of Cash Flows

Years ended June 30, 2006 and 2005

	<u>2006</u>	<u>2005</u>
Cash flows from operating activities:		
Net income	\$ 235,265	649,596
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation	113,401	60,125
Amortization of premiums/discounts on securities, net	49,065	71,725
Amortization of unearned compensation	—	158,178
Provision for loan losses	15,000	15,000
Deferred income tax provision	67,234	15,888
Gain on loans held for sale	(20,526)	(12,598)
Proceeds from sale of loans held for sale	2,500,526	1,849,738
Loans originated for sale	(2,543,200)	(1,837,140)
Gain on sale of available for sale securities, net	(60,009)	(358,231)
Gain on reclassification of securities	(35,390)	—
Loss on disposal of assets	1,176	—
Change in assets and liabilities:		
Increase in accrued interest and dividends receivable	(68,263)	(1,336)
Decrease (increase) in prepaid expenses and other assets	25,998	(37,604)
(Decrease) increase in other liabilities	(163,331)	109,609
Net cash provided by operating activities	<u>116,946</u>	<u>682,950</u>
Cash flows from investing activities:		
Purchase of securities available for sale	(14,018,668)	(19,707,703)
Purchase of securities held to maturity	(1,000,000)	(1,000,000)
Proceeds from maturities and principal payments on securities available for sale	11,086,590	14,225,146
Proceeds from sales of securities available for sale	2,951,848	2,974,330
Proceeds from maturities and principal payments on securities held to maturity	2,086,698	1,542,949
Sale of Federal Home Loan Bank stock	14,500	283,400
Loan repayments, net	1,805,723	1,930,612
Capital expenditures, net	(101,001)	(183,400)
Net cash provided by investing activities	<u>2,825,690</u>	<u>65,334</u>
Cash flows from financing activities:		
Purchase of treasury stock	(852,341)	(576,564)
Purchase of shares of common stock to fund Trust	—	(863,826)
Federal Home Loan Bank repayments	(833,334)	(833,333)
Cash dividends paid	(279,275)	(293,644)
Increase (decrease) in deposits, net	433,156	(268,564)
(Payments) proceeds from short-term borrowings	(55,000)	55,000
Proceeds from exercise of stock options	268,595	405,142
Net cash used in financing activities	<u>(1,318,199)</u>	<u>(2,375,789)</u>
Net increase (decrease) in cash and cash equivalents	1,624,437	(1,627,505)
Cash and cash equivalents, beginning of year	4,106,500	5,734,005
Cash and cash equivalents, end of year	<u>\$ 5,730,937</u>	<u>4,106,500</u>
Supplemental cash flow information:		
Cash paid during the year for:		
Income taxes, net of refund received	\$ 160,515	279,168
Interest	2,643,257	2,234,355

See accompanying notes to consolidated financial statements.

THE SOUTHERN BANC COMPANY, INC.

Notes to Consolidated Financial Statements

June 30, 2006 and 2005

(1) Organization and Summary of Significant Accounting Policies

(a) *Organization, Nature of Operations, and Principles of Consolidation*

The Southern Banc Company, Inc. (the Company) was incorporated in the State of Delaware in May 1995, for the purpose of becoming a holding company to own all of the outstanding capital stock of The Southern Bank Company (the Bank), formerly First Federal Savings and Loan Association of Gadsden, upon the Bank's conversion from a federally chartered mutual savings association to a federally chartered stock savings association (the Conversion). The accompanying consolidated financial statements include the accounts of the Company and its two wholly owned subsidiaries, the Bank and First Service Corporation. All significant intercompany balances and transactions have been eliminated in consolidation.

The Bank is primarily engaged in the business of obtaining funds in the form of various savings deposit products and investing those funds in mortgage loans or single family real estate and, to a lesser extent, in consumer loans. The Bank operates from its four offices in the northeast portion of Alabama and originates the majority of its loans in this market area.

(b) *Use of Estimates*

The accounting principles and reporting policies of the Company, and the methods of applying these principles, conform with accounting principles generally accepted in the United States of America (GAAP) and general practices within the banking industry. In preparing the consolidated financial statements, management is required to make estimates and assumptions that affect the reported amounts of assets and liabilities as of the date of the consolidated statement of financial condition and income and expense for the period. Actual results could differ significantly from those estimates. A material estimate that is particularly susceptible to significant changes in the near term is the determination of the allowance for loan losses. A substantial portion of the Company's loans are secured by real estate in its primary market area. Accordingly, the ultimate collectibility of a substantial portion of the Company's loan portfolio is susceptible to changes in economic conditions in the Company's primary market area.

(c) *Securities*

Securities have been classified as either available for sale or held to maturity based on management's intentions at the time of purchase. Securities classified as available for sale are carried at fair value. The unrealized difference between amortized cost and fair value on securities available for sale is excluded from earnings and is reported, net of deferred taxes, as a separate component of stockholders' equity. The available for sale classification includes securities that management intends to use as part of its asset/liability management strategy or that may be sold in response to changes in interest rates, liquidity needs, or for other purposes.

Securities designated as held to maturity are carried at amortized cost, as the Company has both the ability and the positive intent to hold these securities to maturity.

Federal Home Loan Bank stock is carried at cost, as there is no readily available market for this stock.

THE SOUTHERN BANC COMPANY, INC.

Notes to Consolidated Financial Statements

June 30, 2006 and 2005

Amortization of premiums and accretion of discounts on mortgage-backed securities and other investments are computed using the level yield method. The adjusted cost of the specific security sold is used to compute gain or loss on the sale of securities.

Declines in the fair value of held to maturity and available for sale securities below their cost that are deemed to be other than temporary, if any, are reflected in earnings as realized losses. In estimating other than temporary impairment losses, management considers independent price quotations, projected target prices of investment analysts within the short term and the financial condition of the issuer.

(d) *Loans and Allowance for Loan Losses*

Loans originated and intended for sale in the secondary market are carried at the lower of cost or estimated fair value in the aggregate. Net unrealized losses, if any, are recognized through a valuation allowance by charges to income. All loans sold in the secondary market are sold servicing released. At June 30, 2006, secondary market loans pending sale totaled \$63,200. There were no secondary market loans pending sale at June 30, 2005.

Loans receivable are stated at unpaid principal balances, less the allowance for loan losses, discounts on loans, unearned interest income, and net deferred loan fees/costs. Unearned interest income on consumer loans is amortized to income by use of a method which approximates level yield over the lives of the related loans.

The allowance for loan losses is established through a provision charged to earnings when losses are estimated to have occurred. Loan losses are charged against the allowance when the loss is recognized. Subsequent recoveries, if any, are credited to the allowance.

The allowance for loan losses is maintained at a level which management considers adequate to absorb losses inherent in the loan portfolio at each reporting date. To serve as a basis for establishing the allowance each quarter, the Bank maintains an extensive credit risk monitoring process that considers several factors including: current economic conditions affecting the Bank's customers, the payment performance of individual large loans and pools of homogeneous small loans, distribution of loans by risk class, portfolio seasoning, changes in collateral values, and detailed reviews of specific large loan relationships. Though management believes the allowance for loan losses is adequate, ultimate losses may vary from estimates; however, estimates are reviewed periodically and, as adjustments become necessary, they are reported in earnings in the periods in which they become known.

Impaired loans (generally considered to be nonperforming loans, excluding residential mortgages and other homogeneous loans) are measured based on the present value of expected future cash flows discounted at each loan's original effective interest rate. As a practical expedient, impairment is measured based on the loan's observable market price or the fair value of the collateral if the loan is collateral dependent. When the measure of the impaired loan is less than the recorded investment of the loan, the impairment is recorded through a valuation allowance. The Company had no loans designated as impaired at either June 30, 2006 or 2005.

THE SOUTHERN BANC COMPANY, INC.

Notes to Consolidated Financial Statements

June 30, 2006 and 2005

The Company ceases accrual of interest on a loan when payment on the loan is in excess of 90 days past due. Income is subsequently recognized only to the extent that cash payments are received until, in management's judgment, the borrower's ability to make periodic interest and principal payments has been reestablished, in which case the loan is returned to accrual status.

The Company enters into interest rate locks, where customers have locked into mortgages at a set interest rate, and forward sales commitments, which are sales of mortgage loans to third parties at a specified price. These interest rate locks and forward sales commitments qualify as derivatives; however, the change in fair value of these derivatives during the year did not have a material impact on the Company's financial position or results of operations.

(e) *Loan Origination Fees and Related Costs and Discounts*

Loan fees and certain direct costs of loan origination are deferred, and the net fee or cost is recognized as an adjustment to interest and fees on loans in the accompanying consolidated statements of income using the level yield method over the contractual life of the loans. Discounts associated with loans purchased are deferred and accreted to income over the contractual life of the loans using the level yield method.

(f) *Premises and Equipment*

Land is reported at cost. Building, furniture and equipment, and automobiles are stated at cost, less accumulated depreciation. Leasehold improvements are amortized using the straight-line method over the shorter of the estimated lives or the applicable lease periods. Depreciation methods and estimated service lives are as follows:

Building and improvements	10 – 40 years	Accelerated/Straight-line
Leasehold improvements	10 years	Straight-line
Furniture and equipment	5 – 20 years	Accelerated/Straight-line
Automobile	3 years	Straight-line

(g) *Stock Based Compensation*

The Company applies Accounting Principles Bulletin (APB) Opinion 25, *Accounting for Stock Issued to Employees*, and related interpretations in accounting for employee stock compensation plans and, accordingly, does not recognize compensation cost for stock options granted when the option price is greater than or equal to the underlying stock price. This accounting method is referred to as the intrinsic value method. The Company follows the pro-forma disclosures of Statement of Financial Accounting Standards (SFAS) No. 123, as amended by SFAS No. 148, *Accounting for Stock-Based Compensation — Transition and Disclosure*, using the fair value method of accounting for stock-based compensation.

THE SOUTHERN BANC COMPANY, INC.

Notes to Consolidated Financial Statements

June 30, 2006 and 2005

If the Company had elected to recognize compensation cost for options based on the fair value of the options as permitted by SFAS No. 123, net income and earnings per share would have remained unchanged as indicated below:

	<u>2006</u>	<u>2005</u>
Net income:		
As reported	\$ 235,265	649,596
Less stock based compensation expense	<u>—</u>	<u>—</u>
Pro forma	<u>\$ 235,265</u>	<u>649,596</u>
Earnings per share:		
As reported:		
Basic	\$ 0.30	0.78
Diluted	0.29	0.76
Pro forma:		
Basic	0.30	0.78
Diluted	0.29	0.76

(h) *Statements of Cash Flows*

The Company considers cash on hand and in other banks and interest-bearing deposits in other banks to be cash and cash equivalents.

(i) *Recent Accounting Pronouncements*

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 123 (revised 2004) *Share-Based Payment*. The Statement is a revision of FASB Statement No. 123, *Accounting for Stock-Based Compensation*. This Statement supersedes APB Opinion No. 25, *Accounting for Stock Issued to Employees*, and its related implementation guidance. The Statement establishes standards for the accounting for transactions in which an entity exchanges its equity instruments for goods or services. It also addresses transactions in which an entity incurs liabilities in exchange for goods or services that are based on the fair value of the entity's equity instruments or that may be settled by the issuance of those equity instruments. The Statement focuses primarily on accounting for transactions in which an entity obtains employee service in share-based payment transactions. The Statement requires a public entity to measure the cost of employee services received in exchange for an award of equity instruments based on the grant-date fair value of the award (with limited exceptions). That cost will be recognized over the period during which an employee is required to provide service in exchange for the award- the requisite service period (usually the vesting period). No compensation cost is recognized for equity instruments for which employees do not render the requisite service. The Statement eliminates the alternative to use APB Opinion 25's intrinsic value method of accounting that was provided in Statement 123 as originally issued. Under Opinion 25, issuing stock options to employees generally resulted in recognition of no compensation cost. The Statement is effective for public entities that file as small business issuers as of the beginning of the first annual reporting period that begins after December 15, 2005. The Company adopted the Statement on July 1, 2006, and is currently evaluating the effects on the Company's financial statements.

THE SOUTHERN BANC COMPANY, INC.

Notes to Consolidated Financial Statements

June 30, 2006 and 2005

In May 2005, the FASB issued Statement of Financial Accounting Standards No. 154, "Accounting Changes and Error Corrections — a replacement of APB Opinion No. 20 and FASB Statement No. 3" (Statement 154). Statement 154 changes the requirements for the accounting for and reporting of a change in accounting principle. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. When a pronouncement includes specific transition provisions, those provisions should be followed. Statement 154 is effective for accounting changes and corrections of errors made in fiscal years beginning after December 15, 2005. The Company does not expect the adoption of Statement 154 to have a material effect on the consolidated financial statements.

In November 2005 the FASB issued Staff Position Statement of Financial Accounting Standards 115-1, "The Meaning of Other Than-Temporary Impairment and Its Application to Certain Investments" (FSP 115-1). This FSP outlines guidance for determining when an investment is considered impaired, when such impairment is considered other than temporary and the measurement of any resulting impairment loss. FSP 115-1 also provides certain disclosure requirements for securities and their fair values. The FSP is effective for reporting periods beginning after December 15, 2005. The Company does not expect the adoption of this FSP to have a material impact on the consolidated financial statements.

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(2) Securities Available for Sale

The amortized cost, gross unrealized gain and loss, and estimated fair value of securities designated as available for sale are summarized as follows:

	June 30, 2006			
	Amortized cost	Gross unrealized gain	Gross unrealized (loss)	Fair value
U.S. Government agency securities	20,232,924	24,937	(523,210)	19,734,651
U.S. Treasury securities	757,165	17,031	(3,848)	770,348
Mortgage-backed securities	33,992,328	10,870	(1,515,803)	32,487,395
Other	4,807,381	—	(176,745)	4,630,636
	<u>\$ 59,789,798</u>	<u>52,838</u>	<u>(2,219,606)</u>	<u>57,623,030</u>
	June 30, 2005			
	Amortized cost	Gross unrealized gain	Gross unrealized (loss)	Fair value
U.S. Government agency securities	\$ 7,934,201	29,142	(304,218)	7,659,125
Mortgage-backed securities	44,914,301	1,122,801	(1,692,200)	44,344,902
Other	6,957,138	509,003	(66,835)	7,399,306
	<u>\$ 59,805,640</u>	<u>1,660,946</u>	<u>(2,063,253)</u>	<u>59,403,333</u>

THE SOUTHERN BANC COMPANY, INC.

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The amortized cost and estimated fair value of debt securities available for sale by contractual maturity are shown below. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

	June 30, 2006	
	Amortized cost	Fair value
U.S. Government agency securities:		
Due in one year or less	\$ 2,132,245	2,118,278
Due after one year through five years	7,873,489	7,730,536
Due after five years through ten years	7,939,384	7,653,603
Due after ten years	2,287,806	2,232,234
	20,232,924	19,734,651
U.S. Treasury securities	757,165	770,348
Mortgage-backed securities	33,992,328	32,487,395
Other	4,807,381	4,630,636
	\$ 59,789,798	57,623,030

Proceeds from sales of available for sale securities were \$2,951,848 and \$2,974,330 in 2006 and 2005, respectively. Gross gains of \$66,009 and \$361,650 were realized on these sales in 2006 and 2005, respectively. Gross losses of \$6,000 and \$3,419 were realized on these sales in 2006 and 2005, respectively.

Securities designated as available for sale with carrying values (fair values) of \$1,962,299 have been pledged as collateral for certain large deposits (public funds) with an aggregate balance of \$1,325,000 at June 30, 2006.

The following table shows the Company's combined investments' gross unrealized losses and fair values, aggregated by investment category and length of time that individual securities have been in continuous unrealized loss position, at June 30, 2006:

	Less than 12 months		More than 12 months		Total	
	Fair value	Unrealized gross losses	Fair value	Unrealized gross losses	Fair value	Unrealized gross losses
U.S. Government agency securities	\$ 15,299,840	(342,750)	3,193,509	(180,460)	18,493,349	(523,210)
U.S. Treasury securities	261,152	(3,848)	—	—	261,152	(3,848)
Mortgage-backed securities	8,098,196	(257,731)	23,333,925	(1,258,072)	31,432,121	(1,515,803)
Other	2,503,517	(51,552)	2,125,404	(125,193)	4,628,921	(176,745)
	\$ 26,162,705	(655,881)	28,652,838	(1,563,725)	54,815,543	(2,219,606)

At June 30, 2006, the Company had 127 individual available-for-sale securities that were in an unrealized loss position. All of these securities' impairments are deemed not to be other than temporary impairments

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and were primarily due to the fact that these securities experienced volatility in their market prices as a result of current market conditions, with no credit concerns related to the entities that issued the securities.

(3) Securities Held to Maturity

The amortized cost, gross unrealized gain and loss, and estimated fair value of securities designated as held to maturity are summarized as follows:

June 30, 2006				
	Amortized cost	Gross unrealized gain	Gross unrealized (loss)	Fair value
Mortgage-backed securities	\$ 1,580,447	35,494	—	1,615,941
Other	1,000,000	—	—	1,000,000
	<u>\$ 2,580,447</u>	<u>35,494</u>	<u>—</u>	<u>2,615,941</u>
June 30, 2005				
	Amortized cost	Gross unrealized gain	Gross unrealized (loss)	Fair value
Mortgage-backed securities	\$ 2,656,198	124,784	—	2,780,982
Other	1,003,931	71	—	1,004,002
	<u>\$ 3,660,129</u>	<u>124,855</u>	<u>—</u>	<u>3,784,984</u>

The amortized cost and estimated fair value of debt securities held to maturity by contractual maturity are shown below. Expected maturities may differ from contractual maturities because issuers may have the right to call or prepay obligations with or without call or prepayment penalties.

June 30, 2006		
	Amortized cost	Fair value
Mortgage-backed securities	1,580,447	1,615,941
Other	1,000,000	1,000,000
	<u>\$ 2,580,447</u>	<u>2,615,941</u>

THE SOUTHERN BANC COMPANY, INC.

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(4) Loans Receivable, Net

Loans receivable are summarized as follows:

	2006	2005
Mortgage loans:		
Secured by one-to-four family residential properties	\$ 21,994,329	24,598,109
Secured by nonresidential properties	1,156,762	1,298,292
Consumer loans	7,289,535	7,729,154
Savings account loans	895,910	843,369
Commercial loans	2,565,393	1,306,165
	<u>33,901,929</u>	<u>35,775,089</u>
Less:		
Unearned interest income	23,871	83,489
Deferred loan costs, net	28,867	25,153
Allowance for loan losses	138,939	135,472
Loans receivable, net	<u>\$ 33,710,252</u>	<u>35,530,975</u>

As a savings and loan institution, the Bank has a credit concentration in residential real estate mortgage loans. Substantially all of the Bank's customers are located in its trade area of Etowah, Marshall, and Cherokee Counties in Alabama. Although management believes that the Bank has generally conservative underwriting standards, including a collateral policy of low loan to collateral values, the ability of its borrowers to meet their residential mortgage obligations is dependent upon local economic conditions.

In the normal course of business, loans are made to officers, directors, and employees of the Company and the Bank. These loans are made on substantially the same terms, including interest rates and collateral, as those prevailing for comparable transactions with others. As of June 30, 2006 and 2005, \$362,660 and \$335,316, respectively, of these loans were outstanding. The change from June 30, 2005 to June 30, 2006 reflects payments amounting to \$231,481 and advances of \$258,825 made during the year.

An analysis of the Company's allowance for loan losses is as follows:

	Years ended June 30	
	2006	2005
Balance, beginning of year	\$ 135,472	144,298
Provision for loan losses	15,000	15,000
Charge-offs	(11,533)	(23,826)
Balance, end of year	<u>\$ 138,939</u>	<u>135,472</u>

At June 30, 2006 and 2005, nonaccrual loans totaled \$82,520 and \$30,567, respectively. Neither cash income recognized nor interest income foregone on nonaccrual loans was significant for fiscal years 2006 and 2005, respectively.

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(5) Accrued Interest and Dividends Receivable

Accrued interest and dividends receivable is summarized as follows:

	June 30	
	2006	2005
Securities available for sale	\$ 377,432	288,915
Securities held to maturity	17,734	29,082
Loans receivable, net	107,146	117,246
Federal Home Loan Bank stock	6,903	5,709
	<u>\$ 509,215</u>	<u>440,952</u>

(6) Premises and Equipment, Net

Premises and equipment are summarized as follows:

	June 30	
	2006	2005
Land	\$ 415,486	340,486
Building and improvements	915,787	487,031
Leasehold improvements	—	11,390
Furniture, fixtures, and equipment	422,037	414,967
	<u>1,753,310</u>	<u>1,253,874</u>
Less accumulated depreciation and leasehold amortization	<u>(706,847)</u>	<u>(645,034)</u>
	<u>\$ 1,046,463</u>	<u>608,840</u>

Depreciation and leasehold amortization expense charged to office building and equipment expense in 2006 and 2005 totaled approximately \$113,401 and \$60,125, respectively.

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(7) Deposits

Deposits are summarized as follows:

	June 30, 2006		June 30, 2005	
	Amount	Percent	Amount	Percent
Demand, NOW, and money market accounts, including non-interest bearing deposits of \$513,960 and \$396,932 at June 30, 2006 and 2005 respectively	\$ 15,503,642	18.87%	17,011,465	20.81%
Passbook savings	3,563,648	4.33%	4,875,818	5.97%
	19,067,290	23.20%	21,887,283	26.78%
Certificates of deposit:				
0.01 – 2.00% interest rate	3,997,517	4.87%	6,945,662	8.50%
2.01 – 4.00% interest rate	30,574,873	37.21%	47,369,228	57.95%
4.01 – 6.00% interest rate	28,529,993	34.72%	5,534,344	6.77%
	63,102,383	76.80%	59,849,234	73.22%
	<u>\$ 82,169,673</u>	<u>100.00%</u>	<u>81,736,517</u>	<u>100.00%</u>

The aggregate amount of jumbo certificates of deposit with a minimum denomination of \$100,000 was \$17,964,976 and \$14,095,187 at June 30, 2006 and 2005, respectively.

At June 30, 2006, the scheduled maturities of time deposits are as follows:

2007	\$ 34,936,634
2008	11,694,622
2009	7,775,289
2010	5,217,848
2011	3,452,294
Thereafter	25,696
Total	<u>\$ 63,102,383</u>

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Interest expense on deposits consisted of the following:

	Years ended June 30	
	2006	2005
Passbook savings	\$ 22,445	30,864
NOW and money market accounts	236,300	216,527
Certificates of deposit	2,117,995	1,689,764
	<u>\$ 2,376,740</u>	<u>1,937,155</u>

(8) Income Taxes

The provision for income taxes for the periods indicated is summarized as follows:

	Years ended June 30	
	2006	2005
Current provision:		
Federal	\$ 64,766	336,040
State	10,368	41,765
	<u>75,134</u>	<u>377,805</u>
Deferred provision	67,234	15,888
	<u>\$ 142,368</u>	<u>393,693</u>

The differences between the provision for income taxes and the amount computed by applying the statutory federal income tax rate of 34% to income before taxes were as follows:

	Years ended June 30	
	2006	2005
Pretax income at statutory rates	\$ 128,395	354,718
Add:		
State income tax, net of federal tax benefit	10,184	30,639
Other, net	3,789	8,336
	<u>\$ 142,368</u>	<u>393,693</u>
Effective tax rate	38%	38%

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The components of the net deferred tax asset or liability at June 30, 2006 and 2005 were as follows:

	June 30	
	2006	2005
Accumulated amortization of intangibles	\$ 24,566	33,260
Allowance for loan losses, net	25,617	23,967
Accruals for employee benefit plans	117,030	138,279
Unrealized net loss on securities available for sale	816,872	157,522
Fixed Assets	1,809	16,748
Deferred tax asset	985,894	369,776
Federal Home Loan Bank stock dividend	(19,577)	(20,152)
Accretion of discount on securities	(245,936)	(235,019)
Deferred loan fees and costs, net	(168,703)	(155,043)
Deferred tax liability	(434,216)	(410,214)
Net deferred tax asset/(liability)	\$ 551,678	(40,438)

The portion of a thrift's tax bad debt allowance that was not recaptured under the provisions of the Small Business Job Protection Act of 1996 is only subject to recapture at a later date under certain circumstances. These circumstances include stock repurchases and redemptions by the thrift or conversion of the thrift to a type of institution (such as a credit union) that is not considered a bank for tax purposes. However, no further recapture would be required if the thrift converted to a commercial bank charter or was acquired by a bank. The Bank does not anticipate engaging in any transactions at this time that would require the recapture of its pre-1988 tax bad debt allowance of approximately \$2.8 million.

(9) Federal Home Loan Bank Advances

Federal Home Loan Bank advances at June 30, 2006 consisted of the following:

5.20% note payable, due September 20, 2006	\$ 2,000,000
3.22% note payable, due December 4, 2006	1,000,000
4.08% note payable, due October 17, 2007	577,107
4.16% note payable, due October 17, 2007	672,893
5.72% note payable, due March 19, 2008	1,000,000
	<u>\$ 5,250,000</u>

The Federal Home Loan Bank notes are payable to the Federal Home Loan Bank of Atlanta and are secured by the Federal Home Loan Bank stock owned by the Bank with a carrying value of \$494,400, as well as a pledge of certain securities with a carrying value of \$10,375,720 at June 30, 2006. Interest rates on the notes are fixed and interest is payable monthly. Principal on the notes is payable at maturity or in semiannual principal reductions until maturity.

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Scheduled principal payments required for Federal Home Loan Bank advances are as follows:

2007	3,833,333
2008	<u>1,416,667</u>
	<u>\$ 5,250,000</u>

(10) Commitments and Contingencies

(a) Leases

The Company had operating lease agreements for one of its branch offices, which expired in October 2005. Rental expense under these leases aggregated \$2,814 for fiscal year 2006 and \$7,364 for fiscal year 2005. The Company had no rental commitments or leases at June 30, 2006.

(b) Off-Balance-Sheet Items

The Company's policies as to collateral and assumption of credit risk for off-balance sheet items are essentially the same as those for extension of credit to its customers. Generally, the off-balance sheet exposures the Bank has are its commitments to fund unused lines of credit. At June 30, 2006, the Company had \$310,000 in outstanding commitments to originate residential real estate loans. Additionally, at June 30, 2006, the Bank had provided approximately \$1,833,821 in unused lines of credit.

(c) Litigation

The Company is a party to litigation and claims arising in the normal course of business. Management, after consultation with legal counsel, believes that the liabilities, if any, arising from such litigation and claims will not be material to the consolidated financial statements.

(11) Stockholders' Equity

(a) Regulatory Matters

The Bank is subject to various regulatory capital requirements administered by the federal banking agencies. Failure to meet minimum capital requirements can initiate certain mandatory and possibly additional discretionary actions by regulators that, if undertaken, could have a direct material effect on the Bank's financial statements. Under capital adequacy guidelines and the regulatory framework for prompt corrective action, the Bank must meet specific capital guidelines that involve quantitative measures of the Bank's assets, liabilities, and certain off-balance sheet items as calculated under regulatory accounting practices. The Bank's capital amounts and classifications are also subject to qualitative judgments by the regulators about components, risk weightings, and other factors.

Quantitative measures established by regulation to ensure capital adequacy require the Bank to maintain minimum amounts and ratios (set forth in the table which follows) of Total and Tier 1

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capital (as defined in the regulations) to risk-weighted assets (as defined), and of Tier 1 capital (as defined) to average assets (as defined). Management believes, as of June 30, 2006 and 2005, that the Bank met all capital adequacy requirements to which it is subject.

As of June 30, 2006 the most recent notification from the regulatory authorities categorized the Bank as well capitalized under the regulatory framework for prompt corrective action. To be categorized as well capitalized, the Bank must maintain minimum Total risk-based, Tier 1 risk-based, and Tier 1 leverage ratios as set forth in the tables which follow.

Actual capital amounts and ratios are presented in the table below for the Company and the Bank:

	Actual		For capital adequacy purposes		To be well capitalized under prompt corrective action provisions	
	Amount	Ratio	Amount	Ratio	Amount	Ratio
(Dollars in thousands)						
June 30, 2006:						
Total capital (to risk weighted assets):						
Consolidated	\$ 16,429	40.0%	\$ 3,283	8.0%	\$ N/A	N/A
Southern Bank Company	14,401	35.1%	3,283	8.0%	4,103	10.0%
Tier 1 (core) capital (to risk weighted assets):						
Consolidated	16,290	39.7%	1,641	4.0%	N/A	N/A
Southern Bank Company	14,262	34.8%	1,641	4.0%	2,462	6.0%
Tier 1 (core) capital (to adjusted total assets):						
Consolidated	16,290	15.6%	4,189	4.0%	N/A	N/A
Southern Bank Company	14,262	13.6%	4,189	4.0%	5,239	5.0%
Tangible capital (to adjusted total assets):						
Consolidated	16,290	15.6%	1,571	1.5%	N/A	N/A
Southern Bank Company	14,262	13.6%	1,571	1.5%	N/A	N/A
June 30, 2005:						
Total capital (to risk weighted assets):						
Consolidated	\$ 17,054	46.3%	\$ 2,945	8.0%	\$ N/A	N/A
Southern Bank Company	15,877	43.1%	2,945	8.0%	3,681	10.0%
Tier 1 (core) capital (to risk weighted assets):						
Consolidated	16,918	46.0%	1,472	4.0%	N/A	N/A
Southern Bank Company	15,741	42.8%	1,472	4.0%	2,208	6.0%
Tier 1 (core) capital (to adjusted total assets):						
Consolidated	16,918	16.0%	4,241	4.0%	N/A	N/A
Southern Bank Company	15,741	14.8%	4,241	4.0%	5,302	5.0%
Tangible capital (to adjusted total assets):						
Consolidated	16,918	16.0%	1,590	1.5%	N/A	N/A
Southern Bank Company	15,741	14.8%	1,590	1.5%	N/A	N/A

Pursuant to regulations, an institution that exceeds all fully phased-in capital requirements before and after a proposed capital distribution and has not been advised by the Office of Thrift Supervision (OTS) that it is in need of more than the normal supervision can, after prior notice but without the approval of the OTS, make capital distributions during a calendar year equal to the greater of (i) 100% of its net income to date during the calendar year plus the amount that would reduce by one-half its "surplus capital ratio" (the excess capital over its fully phased-in capital requirements) at the beginning of the calendar year, or (ii) 75% of its net income over the most recent four-quarter period. Any additional capital distributions require prior regulatory approval.

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The Company's principal source of funds for dividend payments is dividends from the Bank. Certain restrictions exist regarding the ability of the Bank to pay dividends to the Company. At July 1, 2006, dividend payments by the Bank were subject to regulatory approval. The Company's ability to pay dividends will be largely dependent upon dividends to the Company from the Bank. Pursuant to the OTS regulations, the Bank will not be permitted to pay dividends on its capital stock or repurchase shares of its stock if its stockholders' equity would be reduced below the amount required for the liquidation account or if stockholders' equity would be reduced below the amount required by the OTS.

(b) Comprehensive Income

Comprehensive income is the change in equity during a period from transaction and other events and circumstances from non-owner sources. For the Company, comprehensive income includes changes in unrealized gains and losses on securities available-for-sale and net income.

In the determination of comprehensive income, certain reclassification adjustments are made to avoid double-counting items that are displayed as part of the net income and accumulated other comprehensive income in that period or earlier periods. The following table reflects the reclassification amounts and the related tax effects for the two years ended June 30:

		2006		
		Before tax amount	Tax effect	After tax amount
Unrealized losses arising during the year	\$	(1,704,452)	641,893	(1,062,559)
Reclassification for adjustments for gains included in net earnings		(60,009)	22,599	(37,410)
Net change in unrealized losses on securities	\$	<u>(1,764,461)</u>	<u>664,492</u>	<u>(1,099,969)</u>
		2005		
		Before tax amount	Tax effect	After tax amount
Unrealized gains arising during the year	\$	166,526	(57,700)	108,826
Reclassification for adjustments for gains included in net earnings		(358,231)	135,053	(223,178)
Net change in unrealized losses on securities	\$	<u>(191,705)</u>	<u>77,353</u>	<u>(114,352)</u>

(12) Earnings Per Share

Basic earnings per share were computed by dividing net income by the weighted average number of shares of common stock outstanding during the years ended June 30, 2006 and 2005. Common stock outstanding consists of issued shares less treasury stock, unallocated Employee Stock Ownership Plan (ESOP) shares

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(see Note 13), and shares held in trust. Diluted earnings per share for the years ended June 30, 2006 and 2005 was computed by dividing net income by the weighted average number of shares of common stock outstanding and the dilutive effects of the shares awarded under the Stock Option Plan, based on the treasury stock method, using an average fair market value of the stock during the respective periods.

The following table represents the earnings per share calculations for the years ended June 30, 2006 and 2005:

	<u>Income</u>	<u>Shares</u>	<u>Per share amount</u>
2006:			
Basic earnings per share	\$ 235,265	796,289	\$ 0.30
Dilutive securities:			
Incentive stock option plan shares	<u>—</u>	<u>12,129</u>	
Dilutive earnings per share	<u>\$ 235,265</u>	<u>808,418</u>	0.29
2005:			
Basic earnings per share	\$ 649,596	836,034	\$ 0.78
Dilutive securities:			
Incentive stock option plan shares	<u>—</u>	<u>18,319</u>	
Dilutive earnings per share	<u>\$ 649,596</u>	<u>854,353</u>	0.76

(13) Employee Retirement and Savings Plans

(a) Employee Stock Ownership Plan

In connection with the Conversion, the Bank established an ESOP for eligible employees. The ESOP purchased 116,380 shares of the Company's common stock with the proceeds of a \$1,163,800 note payable to the Bank and secured by the common stock owned by the ESOP. Principal payments under the note were due in equal annual installments through December 2005; interest was payable annually at a variable rate which was adjusted each January 1.

Expense related to the ESOP was approximately \$0 and \$124,000 for 2006 and 2005. There was no unearned compensation related to the ESOP for the fiscal years ended June 30, 2006 and 2005.

The difference between the fair value of shares committed to be released and the cost of those shares to the ESOP (i.e. unearned compensation) was charged/credited to additional paid-in capital in accordance with AICPA Statement of Position 93-6, *Employers' Accounting for Employee Stock Ownership Plans*. Unearned compensation was amortized into compensation expense based on employee services rendered in relation to shares which were committed to be released based on the fair value of shares.

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(b) *Simplified Employee Pension Plan*

The Company established a Simplified Employee Pension Plan (SEP) for all employees who have completed one year of service, pursuant to Section 408(k) of the Internal Revenue Code of 1986. The Company can make a discretionary contribution to the SEP each year. The cost to the Company under the SEP was \$112,568 and \$49,208 for fiscal years 2006 and 2005, respectively.

(c) *Employment Agreements*

The Company has a 36-month employment agreement with its President and Vice President. These agreements provide that if employment under the agreement is terminated by the Company in connection with or within 12 months after any change in control of the Company, each employee will be paid approximately three times his salary.

(14) *Stock-Based Compensation Plan*

The Company has a stockholder-approved Option Plan. The Option Plan provides for the grant of incentive stock options (ISO's) to employees and nonincentive stock options (non-ISO's) to nonemployee directors. The Company utilizes the intrinsic value method of accounting for stock option grants. As the option price is equal to the fair value of the stock at the date of grant, no compensation cost is recognized.

Under the Option Plan, the Company may grant options up to 145,745 shares and has granted options outstanding of 11,491 shares through June 30, 2006. Under the Option Plan, the options vest 20% per year and become exercisable upon the participant's completion of five years of service.

The Company purchased shares in the open market to be issued upon exercise of stock options. Such shares are reflected at cost as shares held in trust in the accompanying consolidated statements of financial condition. During fiscal year 2006 and 2005, the Company purchased 0 and 49,073 shares, respectively to be used for the exercise of options.

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A summary of the status of the Company's Option Plan at June 30, 2006 and 2005 and the changes during the years then ended is as follows:

	2006		2005	
	Shares	Weighted average exercise price	Shares	Weighted average exercise price
Outstanding at beginning of year:	46,980	\$ 12.35	81,496	\$ 12.09
Forfeitures	(13,902)	—	—	—
Exercised	(21,587)	11.69	(34,516)	11.74
Granted	—	—	—	—
Outstanding at end of year	11,491	\$ 14.38	46,980	\$ 12.35
Exercisable at end of year	11,491	\$ 14.38	46,980	\$ 12.35
Weighted average fair value of the options granted	N/A		N/A	

(15) Fair Value of Financial Instruments

The Company has a variety of financial instruments which include items recorded on the consolidated statement of financial condition and items which, by their nature, are not recorded on the consolidated statement of financial condition. Quoted market prices, if available, are utilized as an estimate of the fair value of financial instruments. In cases where quoted market prices are not available, fair values have been estimated using present value or other valuation techniques. These methods are highly sensitive to the assumptions used by management, such as those concerning appropriate discount rates and estimates of future cash flows. Different assumptions could significantly affect the estimated fair value amounts presented below. In this regard, the derived fair value estimates cannot be substantiated by comparison to independent markets and, in many cases, could not be realized in the immediate settlement of the instrument. Further, assets that are not financial instruments are not included in the following table. Accordingly, the aggregated estimated fair value amounts presented do not represent the underlying value of the Company.

THE SOUTHERN BANC COMPANY, INC.

Notes to Consolidated Financial Statements

June 30, 2006 and 2005

This table summarizes the Company's carrying amount and fair value of financial instruments:

	2006		2005	
	Carrying amount	Estimated fair value	Carrying amount	Estimated fair value
	(in thousands)		(in thousands)	
Assets:				
Cash on hand and in banks	\$ 5,731	5,731	4,107	4,107
Securities – available for sale	57,623	57,623	59,403	59,403
Securities – held to maturity	2,580	2,616	3,660	3,789
Federal Home Loan Bank stock	494	494	509	509
Loans held for sale	63	63	—	—
Loans receivable, net	33,710	29,233	35,531	38,144
Accrued interest and dividends receivable	509	509	441	441
Liabilities:				
Deposits	82,170	81,528	81,737	81,403
Federal Home Loan Bank advances	5,250	5,022	6,083	6,159
Accrued interest payable	35	35	36	36

The following methods and assumptions were used by the Company in estimating the fair values provided above:

(a) Cash and Cash Equivalents

The carrying value of highly liquid instruments, such as cash on hand and cash equivalents, are considered to approximate their fair value.

(b) Securities Available for Sale and Securities Held to Maturity

Substantially all of the Company's securities available for sale and held to maturity have a readily determinable fair value. Fair values for these securities are based on quoted market prices, where available. If not available, fair values are based on market prices of comparable instruments. The carrying value of accrued interest on these instruments approximates fair value.

(c) Federal Home Loan Bank Stock

The Federal Home Loan Bank has historically repurchased its stock at cost. Therefore, the carrying amount is considered a reasonable estimate of its fair value.

THE SOUTHERN BANC COMPANY, INC.

Notes to Consolidated Financial Statements

June 30, 2006 and 2005

(d) *Loans Held for Sale*

The fair value of loans held for sale is estimated using market rates, which approximate carrying values.

(e) *Loans Receivable, Net*

For loans with rates which are repriced in coordination with movements in market rates and with no significant change in credit risk, fair value estimates are based on carrying values. The fair values for certain mortgage loans are based on quoted market prices of similar loans sold in conjunction with securitizing transactions, adjusted for differences in loan characteristics. The fair values of other loans are estimated by discounting future cash flows using current rates at which loans with similar terms would be made to borrowers of similar credit ratings.

(f) *Accrued Interest Receivable*

The carrying amount of accrued interest receivable approximates its fair value.

(g) *Deposits*

The fair value of deposits with no stated maturity, such as interest and non-interest demand deposits, NOW accounts, savings accounts, and money market accounts, is, by definition, equal to the amount payable on demand at the reporting date (i.e., their carrying amounts). Fair values for certificates of deposit are estimated using a discounted cash flow analysis that applies rates currently offered for certificates of similar remaining maturities.

(h) *FHLB Advances*

Rates currently available to the Company for debt with similar terms and remaining maturities are used to estimate the fair value of existing FHLB advances.

(i) *Accrued Interest Payable*

The carrying amount of accrued interest payable approximates its fair value.

(j) *Off-Balance-Sheet Instruments*

Off-balance-sheet financial instruments include commitments to extend credit. The fair value of such commitments is not material to the Company's financial condition since there is no known credit risk for the Company to consider in its valuation.

THE SOUTHERN BANC COMPANY, INC.

Notes to Consolidated Financial Statements

June 30, 2006 and 2005

(16) Parent Company Financial Statements

Separate condensed financial statements of The Southern Banc Company, Inc. (the Parent Company) as of and for the years ended June 30, 2006 and 2005 are presented below:

Statements of Financial Condition

June 30, 2006 and 2005

(Dollar amounts in thousands)

	<u>2006</u>	<u>2005</u>
Assets:		
Cash and cash equivalents	\$ 547	429
Investment in subsidiary	15,808	16,212
ESOP loan receivable	—	20
Other assets	<u>100</u>	<u>74</u>
Total assets	\$ <u>16,455</u>	<u>16,735</u>
Liabilities:		
Other liabilities	\$ 16	32
Stockholders' equity:		
Preferred stock	—	—
Common stock	15	15
Additional paid-in capital	13,998	13,997
Retained earnings	11,653	11,697
Unearned compensation	—	—
Shares held in trust	(451)	(868)
Treasury stock	(8,776)	(7,923)
Accumulated other comprehensive loss	<u>—</u>	<u>(215)</u>
Total stockholders' equity	<u>16,439</u>	<u>16,703</u>
Total liabilities and stockholders' equity	\$ <u>16,455</u>	<u>16,735</u>

THE SOUTHERN BANC COMPANY, INC.

Notes to Consolidated Financial Statements

June 30, 2006 and 2005

Statements of Income

Years ended June 30, 2006 and 2005

(Dollar amounts in thousands)

	<u>2006</u>	<u>2005</u>
Income:		
Interest	\$ <u>5</u>	<u>8</u>
	5	8
Expense	<u>(76)</u>	<u>(77)</u>
Loss before income taxes and equity in undistributed income of subsidiaries	(71)	(69)
Benefit for income taxes	<u>27</u>	<u>27</u>
Loss before equity in undistributed income of subsidiaries	(44)	(42)
Equity in undistributed current year income of subsidiaries	<u>279</u>	<u>692</u>
Net income	\$ <u><u>235</u></u>	<u><u>650</u></u>

THE SOUTHERN BANC COMPANY, INC.

Notes to Consolidated Financial Statements

June 30, 2006 and 2005

Statements of Cash Flows

Years ended June 30, 2006 and 2005

(Dollar amounts in thousands)

	<u>2006</u>	<u>2005</u>
Cash flows from operating activities:		
Net income	\$ 235	650
Adjustments to reconcile net income to net cash used in operating activities:		
Equity in undistributed current years earnings of subsidiaries	(279)	(692)
Increase in other assets	(26)	(66)
(Decrease) increase in other liabilities	(16)	10
Other operating activities, net	<u>47</u>	<u>—</u>
Net cash used in operating activities	(39)	(98)
Cash flows from financing activities:		
Payments received on ESOP loan	20	112
Purchase of treasury stock	(852)	(576)
Dividends received from subsidiary	1,000	1,000
Cash dividends paid to shareholders	(279)	(294)
Purchase of shares to fund option trust	—	(864)
Proceeds from stock options exercised	<u>268</u>	<u>405</u>
Net cash provided by (used in) financing activities	<u>157</u>	<u>(217)</u>
Increase (decrease) in cash and cash equivalents	118	(315)
Cash and cash equivalents, beginning of year	<u>429</u>	<u>744</u>
Cash and cash equivalents, end of year	\$ <u><u>547</u></u>	<u><u>429</u></u>

CORPORATE INFORMATION

Directors and Executive Officers:

Gates Little
Chairman of the Board, President and Chief
Executive Officer of the Company and of the Bank

Craig G. Cantrell
Retired

Thomas F. Dowling, III
Dentist

Grady Gillam
Retired

Rex G. Keeling, Jr.
Pharmacy Consultant and
Real Estate Investor

James B. Little, Jr.
Investment Officer of the Bank and
Vice President of the Company

James B. Little, III
New Capital Partners, LLC
Founder and Partner

Fred Taylor
Owner of Taylor Realty

Officers:

Janice Stephens
Comptroller of the Bank

Teresa Elkins
Vice President of the Bank

Peggy Smith
Secretary-Treasurer of the Company and of the
Bank

Annette Espy
Vice President of the Bank

Judy Cater
Vice President of the Bank

Robb Turner
Assistant Vice President of the Bank

Main Office:

221 S. 6th Street
Gadsden, Alabama

Branch Offices:

625 East Main Street
Albertville, Alabama

2204 Henry Street
Guntersville, Alabama

390 W. Main Street
Centre, Alabama

Independent Registered Public Accountants:

Barfield Murphy Shank & Smith PC
Birmingham, Alabama

General Counsel:

Inzer, Haney & McWhorter, P.A.
Gadsden, Alabama

Securities and Regulatory Counsel:

Jones, Walker, Waechter, Poitevent, Carrere &
Denegre, L.L.P.
Washington, D.C.

Annual Stockholders Meeting:

November 8, 2006 - 5:00 p.m.
The Southern Bank Company
221 S. 6th Street
Gadsden, Alabama
Record Date - September 15, 2006

A copy of the Annual Report on Form 10-KSB
for the fiscal year ended June 30, 2006 as filed
with the SEC will be furnished to stockholders
as of the Record Date upon written request to
the Secretary of the Company, 221 South 6th
Street, Gadsden, AL 35901.

This image shows a single sheet of white paper with horizontal ruling lines. The lines are evenly spaced and run across the width of the page. There are no margins, text, or other markings on the paper.

THE SOUTHERN BANC COMPANY, INC.

221 SOUTH 6TH STREET • GADSDEN, ALABAMA 35901 • (256) 543-3860